Chapter 1

THE GOVERNMENTAL ENVIRONMENT AND GAAP

LEARNING OBJECTIVES

After completing this chapter, you should be able to do the following:

- Recognize the unique aspects of the governmental accounting environment.
- Recognize authoritative guidance on generally accepted accounting principles (GAAP).
- Identify funds and why they are used.
- Recognize the financial reporting model used by governments.

GOVERNMENT ACCOUNTING, DISTINGUISHED

The state and local government arena of accounting is succinctly distinguished from the for-profit accounting many of us are already familiar with. Several elements are very different from the for-profit sector. One core difference is that the purpose of government is not to make a profit, but to provide a service to the citizenry. There are different users of the financial statements than in the for-profit sector. The accounting is different, and there is even a different standards-setting board, GASB, which typically issues two to three new rules each year. Similar, however, to FASB, GASB is subject to the auspices of the Financial Accounting Foundation (FAF).

This course focuses on the fundamentals of governmental accounting. Governmental accounting is the composite activity of analyzing, recording, summarizing, reporting, and interpreting the financial transactions of governments.

Key Environmental Differences Between Government and Business

The state and local government environment is different in a number of ways from the business environment. These differences influence financial reporting objectives. GASB's white paper, *Why Governmental Accounting and Financial Reporting Is—and Should Be—Different,* identifies five environmental differences between governments and for-profit businesses as follows.

Exhibit 1-1 Key Environmental Differences Between Government and For-Profit Organizations

Organizational Purposes
Sources of Revenues
Potential for Longevity
Relationship with Stakeholders
Role of the Budget

Organizational Purposes – Businesses are in the business of making money. The purpose of governments is to enhance or maintain the well-being of citizens by providing public service. Many of the services governments provide are done without a direct relationship to how much the recipient pays. For example, a local library is supported by revenue from taxes, not by charges to the people who actually use the library.

- ***Sources of Revenue***—A difference between government and business is how resources are provided. Governments receive substantial revenues from nonexchange transactions such as taxes and grants. Taxes are provided by involuntary resource providers. The primary source of revenue for a business is voluntary exchange transactions.
- ***Potential for Longevity***—The legal structure of the government is also different from a business. Each state has its own requirements as to the roles and responsibilities among the different levels and branches of government. Because governments have the ability to tax, they rarely go out of business. This longevity is reflected in a long-term view in financial reporting.

- ***Relationship with Stakeholders***—Citizens delegate the operations of the government to elected officials. The public has the right to hold the government to a higher standard of accountability for raising and spending of public funds. Accountability says that these elected officials must provide information about both stewardship and interperiod equity, which addresses the question: Are current year revenues sufficient to pay for services provided that year or will future taxpayers be required to assume the burden of paying for services previously provided?
- ***Role of the Budget***— Control over the level of taxes and the spending of those resources is achieved by budgets legally adopted by elected officials. ***Demonstrating accountability with budget authority is a key objective of governmental financial reporting***.

KNOWLEDGE CHECK

1. Which statement is accurate regarding the governmental environment?

   a. The state and local government environment is different in a number of ways from business and these differences influence financial reporting objectives.
   b. Few governments' resources come from taxes.
   c. The organizational purpose of a government is identical to a business.
   d. The legal structure of governments is the same as businesses.

2. Which statement is accurate regarding the governmental environment?

   a. Governments have the ability to tax, and therefore, often go out of business.
   b. A similarity between government and business is how resources are provided.
   c. Governments are accountable to citizens and taxpayers and must provide them information on how financial resources are used.
   d. Governments have no accountability to citizens.

OBJECTIVES OF FINANCIAL REPORTING

These and other differences in the environment result in governments having unique financial reporting objectives. *Accountability becomes the paramount objective of financial reporting*. GASB states that financial reports should include information that is useful for

- comparing actual financial results with the legally-adopted budget *(budgetary)*;
- assessing financial condition and results of operations *(financial)*;
- assisting in determining compliance with finance-related laws, rules, and regulations *(compliance)*; and
- assisting in evaluating efficiency and effectiveness *(performance)*.

These financial reporting objectives for governments are much broader than those for business organizations. Government's financial statements must include expanded information if they are to meet these financial reporting objectives. Governments are required to produce several different types of financial statements to meet these objectives.

USERS OF FINANCIAL STATEMENTS

The primary users of governmental financial statements are

- taxpayers and citizens;
- oversight and legislative bodies; and
- investors and creditors.

Although not a primary user, management often relies on the financial statements for planning and monitoring purposes.

ELEMENTS OF FINANCIAL STATEMENTS

GASB Concepts Statement No. 4, *Elements of Financial Statements*, establishes definitions for the seven elements of historically based financial statements of state and local governments. See exhibit 1-2.

Exhibit 1-2 Seven Elements of State & Local Government Financial Statements

Elements of a Statement of Financial Position	
1	***Assets*** are resources with present service capacity that the government presently controls. A *resource* is an item that can be drawn on to provide services to the citizenry.
2	***Liabilities*** are present obligations to sacrifice resources that the government has little or no discretion to avoid.
3	A ***deferred outflow of resources*** is a consumption of net assets by the government that is applicable to a future reporting period.
4	A ***deferred inflow of resources*** is an acquisition of net assets by the government that is applicable to a future reporting period.
5	***Net position*** is the residual of all other elements presented in a statement of financial position.
Elements of the Resource Flows Statements	
6	An ***outflow of resources*** is a consumption of net assets by the government that is applicable to the reporting period.
7	An ***inflow of resources*** is an acquisition of net assets by the government that is applicable to the reporting period.

Unique Concepts in Government Accounting

Several unique accounting practices have evolved for state and local governments due to their unique environment, the need to meet the financial reporting objectives, and the financial statement elements stated earlier. Several aspects of the system of accounting used by governments are similar to that used by businesses, such as the use of debits and credits, journals, and ledgers. Additionally, many transactions continue to be recorded under government accounting the same as they are recorded in for-profit accounting. Still, there are several major differences. The key differences are as follows:

- ***Measurement Focus and Basis of Accounting***—The activities of government can broadly be grouped into two categories. *Each category uses a different measurement focus and basis of accounting.* The two categories are as follows:
  - ***Business Type Activities***—*Business-type activities* are those activities of a government carried out primarily to provide specific services in exchange for a specific user charge. Often, it is the intent that these fees to users should cover the cost of providing such services. Common examples of business-type services are water and sewer services. Accounting for this type of activity is very similar to a for-profit organization.
  - ***Governmental Activities***—Activities occurring in a government organization related to the acquisition, use, and balances of spendable financial resources and the related current liabilities, *except for* those activities accounted for as business-type or fiduciary activities. Police services and education are common examples of government services that qualify as governmental activities. Accounting for these types of activities requires a different measurement focus and basis of accounting (MFBOA).
- ***Fund Accounting***—To assist in demonstrating accountability, governments have long reported activities in separate funds. A fund is a fiscal accounting entity with a self-balancing set of accounts in which cash and other financial resources, all related liabilities and residual equities, or balances, and changes therein, are recorded and segregated to carry on specific activities or attain certain objectives in accordance with special regulations, restrictions, or limitations. Funds are used to separately account for financial activities based on legal requirements or management needs.
- ***Budgetary Reporting***—To meet one of the financial reporting objectives, governments must be able to compare actual financial results with the legally adopted budget. Budgets represent much more than a plan for a government; they represent a legally binding document and are often recorded in the accounting system.

Knowledge Check

3. Which statement is accurate regarding budgetary reporting?

   a. To meet one of the financial reporting objectives, governments must be able to compare actual financial results with the legally adopted budget.
   b. Budgets are never recorded in the accounting system.
   c. Budgets represent only a plan for a government.
   d. Budgets are not legally binding.

ORGANIZATIONS REQUIRED TO FOLLOW GASB

GASB is responsible for accounting standards for state and local governments. Before we cover the accounting standard process, let us cover which organizations must follow these standards:

- ***General-Purpose Governments***—Of course, state governments, cities, counties, and towns would follow these rules and are referred to as *general-purpose governments*. General-purpose governments are government organizations that provide a wide range of services to their citizens (such as police, fire, streets, and public works).
- ***Special Purpose Governments***—Other independent government entities are considered to be *special-purpose governments*. Special-purpose governments provide only a single function or a limited number of functions. The most common examples are independent school districts, water and sewer authorities, and other special districts set up to provide a variety of other types of services.

Other entities may also have to follow the accounting standards for state and local governments. For example, some not-for-profit museums, colleges, libraries, commissions, and boards may meet the definition of a government and, therefore, must follow GASB's standards.

Entities that meet at least one of the following must follow GASB's accounting standards:

- Officers of the entity are popularly elected.
- A controlling majority of members of the entity's governing board is appointed (or approved) by officials of at least one state or local government.
- A government is able to unilaterally dissolve the entity, with the entity's net position reverting to a government.
- The entity has the power to enact and enforce a tax levy.
- The entity has the ability to directly issue federally tax-exempt debt.

If the only criterion met is the ability to directly issue federally tax-exempt debt, the presumption that an entity is governmental may be rebutted based on compelling, relevant evidence. An example would be a not-for-profit college that issues or uses a conduit for federally tax-tax exempt debt.

GAAP AND STANDARDS-SETTING ORGANIZATIONS

For external financial statements to be useful, they must be prepared consistently over time and be comparable with other similar entities. To accomplish this goal, external financial statements must be prepared in accordance with GAAP. The following is a list of organizations that have responsibility for setting accounting standards for different types of organizations:

- GASB has the primary responsibility for setting accounting standards for state and local governments (see earlier criteria for organizations that must follow GASB).
- Financial Accounting Standards Board (FASB) has the primary responsibility for setting accounting standards for nongovernmental entities.
- Federal Accounting Standards Advisory Board (FASAB) has the primary responsibility for setting standards for all agencies of the Federal Government.
- International Accounting Standards Board (IASB) has been designated by the Council of the AICPA as the body to establish international financial reporting standards (IFRSs) for both private and public entities.

Additionally, a consultative body, the Governmental Accounting Standards Advisory Council (The Council), assists GASB. The Council consists of representatives interested in governmental accounting and reporting.

THE GAAP HIERARCHY

The following illustration summarizes the GAAP hierarchy for state and local governments under GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*.

Ladder of GAAP Hierarchy
Category A Officially established accounting principles – GASB Statements, including GASB Interpretations currently in effect
Category B GASB Technical Bulletins; GASB Implementation Guides; and literature of the AICPA if specifically cleared by GASB.

In searching for the proper treatment of an item under GAAP, one would start by looking at the highest category of GAAP and then work his or her way down the ladder until guidance can be found. For example, if the accounting treatment for a transaction or other event is not specified by a pronouncement in *Category A*, a governmental entity should consider whether the accounting treatment is specified by an accounting principle from a source in *Category B*. In such cases, if *Category B* contains accounting principles that specify accounting treatments for a transaction or other event, the governmental entity should follow the accounting treatment specified by the accounting principle from the source in *Category B*.

If the accounting treatment for a transaction or other event is not specified by a pronouncement or established in practice as described in *Categories A* or *B*, a governmental entity should consider accounting principles for similar transactions or other events within *Categories A* or *B*, and may consider nonauthoritative accounting literature. A governmental entity should not follow the accounting treatment specified in accounting principles for similar transactions or other events in cases in which those accounting principles either prohibit the application of the accounting treatment to the particular transaction or other event or indicate that the accounting treatment should not be applied by analogy.

Nonauthoritative accounting literature includes the following:

- GASB Concepts Statements
- Pronouncements and other literature of the Financial Accounting Standards Board (FASB)
- Pronouncements and other literature of the Federal Accounting Standards Advisory Board
- Pronouncements and other literature of the International Public Sector Accounting Standards Board, IFRS or the IASB

- AICPA literature that has not been cleared by GASB
- Practices that are widely recognized and prevalent in state and local government
- Literature of other professional associations or regulatory agencies
- Accounting textbooks, handbooks, and articles

The appropriateness of nonauthoritative accounting literature depends on its consistency with the GASB Concepts Statements, relevance to particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority.

WHERE WE ARE NOW

The following statements were finalized by GASB between 2015-2017 and are effective after 2016:

- GASB Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pensions*, replaces GASB Statement No. 43 *Financial Reporting for Postemployment Benefit plans Other than Pension Plans* and No. 57, *OPEB Measurements by Agent Employers*. For OPEB plans administered through trust, the pronouncement aligns very closely with the requirements of GASB 67 for pension plans. The pronouncement is effective for fiscal years beginning after June 15, 2016.
- GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, replaces GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions* and No. 57, *OPEB Measurements by Agent Employers*. For OPEB plans administered through trust, the pronouncement aligns very closely with the requirements of GASB Statement No. 68 for pension plans. The pronouncement is effective for fiscal years beginning after June 15, 2017.
- GASB Statement No 80, *Blending Requirements for Certain Component Units, an amendment* of *GASB Statement No. 14*, amends the blending criteria by adding an additional blending criterion for the presentation of component units. Component units incorporated as not-for-profit corporations where the primary government is the sole corporate member would be required to be blended in the primary government's financial statements. The criterion would not apply to component units required to be included by GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units*. The pronouncement is effective for fiscal years beginning after June 15, 2016.
- GASB Statement No 81, *Irrevocable Split-Interest Agreements*, provides recognition and measurement guidance when the government is a beneficiary of such an agreement. Governments would be required to recognize assets, liabilities, and deferred inflows of resources. The pronouncement is effective for fiscal years beginning after June 15, 2016.
- GASB No. Statement 82, *Pension Issues—an amendment of GASB Statements No. 67, No. 68, and No. 73*, addresses issues regarding (1) the presentation of payroll-related measures in required supplementary information, (2) the selection of assumptions and the treatment of deviations from the guidance in an Actuarial Standard of Practice for financial reporting purposes, and (3) the classification of payments made by employers to satisfy employee (plan member) contribution requirements. The pronouncement is effective for fiscal years beginning after June 15, 2016.
- GASB Statement No. 83, *Certain Asset Retirement Obligations*, establishes criteria for determining the timing and pattern of recognition of a liability and a corresponding deferred outflow of resources for asset retirement obligations The pronouncement is effective for fiscal years beginning after June 15, 2018.
- GASB Statement No. 84, *Fiduciary Activities*, establishes criteria for identifying fiduciary activities of all state and local governments. The focus of the criteria generally is on (1) whether a government is controlling the assets of the fiduciary activity and (2) the beneficiaries with whom a fiduciary

relationship exists. Separate criteria are included to identify fiduciary component units and postemployment benefit arrangements that are fiduciary activities. The pronouncement is effective for fiscal years beginning after December 15, 2018.

- GASB Statement No. 85, *Omnibus 2017*, addresses practice issues that have been identified during implementation and application of certain GASB Statements. This Statement addresses a variety of topics including issues related to blending component units, goodwill, fair value measurement and application, and postemployment benefits (pensions and other postemployment benefits other than pensions [OPEB]). The pronouncement is effective for fiscal years beginning after June 15, 2017.

The following exposure drafts (ED) and Preliminary Views (PV) were issued between 2014 and 2016

- ED-GASB Implementation Guide 20XX-X updates the current implementation guide.
- ED-Implementation Guide for Statements 74 and 75 on Other Postemployment Benefits
- ED-Financial Reporting Model Improvements—Governmental Funds was issued to seek comments and develop guidance on when and how governments report fiduciary activities in their financial statements.
- ED-Leases examines issues related to accounting for leases. The GASB view is that all leases are financings of the right to use an underlying asset and would generally require an asset and liability to be recorded for most leases.
- ED-Certain Debt Extinguishments was issued to seek comments on improvements to the existing guidance related to debt extinguishments using existing resources.

THE FINANCIAL REPORTING MODEL REPORTING TWO WAYS: FUND AND GOVERNMENT-WIDE STATEMENTS

Governments report financial activities in two ways—by funds and for the government as a whole.

FUND FUNDAMENTALS FUNDS

Before a fund is defined, it is important to understand why governments use funds. One reason is because governments receive resources from a variety of sources for a variety of purposes. For example, a city may receive resources from the state to maintain roads or from the federal government to run a reading program. Governments may also hold resources restricted for such things as employee pensions or a required reserve for future debt payments. Governments must be able to demonstrate that they are using resources for the purposes for which they were given.

> In addition, governments are engaged in a diverse range of activities with different operating objectives. For example, many activities are provided without direct charge (for example, police service), while some services are set up to recover full costs (for example, water and sewer services). Governments will want to separately measure these types of activities to see if they are meeting their different financial objectives.

In order to meet the overall objective of accountability, governments must be able to demonstrate compliance with legal and other restrictions placed on resources as well as being able to properly measure the costs of different activities. To do this, governments use several smaller accounting entities called *funds* to provide financial information. Fund accounting provides the means to report financial activities based on different legal requirements as well as operating objectives.

GASB defines a fund as follows:

> A fund is defined as a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations.

This definition contains several important concepts. First, funds are not separate legal entities, but are created by accounting. The "self-balancing set of accounts" concept relates to the fact that each fund will record activity under its own accounting equation, and therefore separate financial statements can be prepared for each fund. Financial reporting by governments emphasizes the activities of funds and fund types. The final part of the definition gives several reasons for having separate funds.

NUMBER OF FUNDS

How many funds does a government need? Will 5, 10, 20, or 50 be enough? That depends on a number of things. Often the accounting system is capable of tracking several different activities within one fund. For example, a government may use one fund to account for all federal restricted operating grants. Another government may set up separate funds for each major grant. What is important is that both governments must be able to demonstrate that they used the resources in compliance with any restrictions placed on those resources. In addition, separate funds must sometimes be used because of accounting or legal requirements.

The following rule should be used to determine the number of funds:

> In general, a government should use the minimum number of funds necessary for sound financial management and/ or to meet legal and accounting requirements.

As the number of funds grows, so do the complexities in budgeting, accounting, and other administrative matters, while flexibility decreases. An organization must maintain a balance between too many and too few funds. Therefore, the number of funds that a government should use becomes a matter of professional judgment.

All governments (except special purpose funds) need at least one fund, called a general fund. Use of additional funds again becomes a matter of legal requirements and professional judgment.

CREATING A NEW FUND

A new fund can be established at any time. For example, a new fund may be mandated due to a new accounting standard or a change in the state constitution. A grant or other restricted revenue source may also require the use of a separate fund. Also, a government may start a new activity that it wants to track separately. The governing board may create a new fund at any time during the year.

A new fund should be established when mandated by legal requirements or through accounting standards. In other cases, management needs to determine if the desired level of financial control and management can be achieved by accounting for an activity within an existing fund or if a separate fund is required.

FUND STRUCTURE

The diverse nature of government activities can be defined into three broad areas: general activities of the government financed primarily by taxes and grants, business-type activities financed primarily by a user fee, and finally, activities where the government is acting in the role of an agent or under a trust agreement. Accordingly, funds used by a governmental organization fall into the following three categories:

1. ***Governmental Funds***—Used to account for the general operations of a government. The emphasis of financial reporting is on the flow of expendable financial resources. The accounting is designed to measure the change in available financial resources, as opposed to "net income." Governmental funds are supported primarily with taxes.
2. ***Proprietary Funds***—Used to account for the business-type operations of a government. The emphasis of financial reporting is similar to those of a business. The accounting is designed to measure operating income, financial position, and cash flows. Proprietary funds are supported primarily with fees and charges for services.
3. ***Fiduciary Funds***—Used to account for resources established under a trust agreement or an agency relationship. These resources cannot be used to support a government's own programs. The accounting is designed to measure resources held for others and changes in those resources.

Within these three major categories of funds, eleven different types of funds can be used. All funds used by governments are defined as one of the 11 fund types. Often a government can have more than one fund of a particular type or, in some cases, have no funds of a particular type.

There are 11 fund types grouped by fund categories.

GOVERNMENTAL FUNDS

1. ***General Fund***—To account for and report all financial resources not accounted for and reported in another fund.
2. ***Special Revenue Funds***— To account for and report the proceeds of specific revenue sources that are restricted or committed to expenditure for specified purposes other than debt service or capital projects. The term *proceeds of specific revenue sources* establishes that one or more specific restricted or committed revenues should be the foundation for a special revenue fund. Those specific restricted or committed revenues may be initially received in another fund and subsequently distributed to a special revenue fund. Those amounts should not be recognized as revenue in the fund initially receiving them; however, those inflows should be recognized as revenue in the special revenue fund in which they will be expended in accordance with specified purposes. Special revenue funds should not be used to account for resources held in trust for individuals, private organizations, or other governments.

The restricted or committed proceeds of specific revenue sources should be expected to continue to comprise a substantial portion of the inflows reported in the fund. Other resources (investment earnings and transfers from other funds, for example) also may be reported in the fund if those resources are restricted, committed, or assigned to the specified purpose of the fund. Governments should discontinue reporting a special revenue fund, and instead report the fund's remaining resources in the general fund, if the government no longer expects that a substantial portion of the inflows will derive from restricted or committed revenue sources.

Governments should disclose in the notes to the financial statements the purpose for each major special revenue fund—identifying which revenues and other resources are reported in each of those funds.

3. ***Capital Projects Funds***—To account for and report financial resources that are restricted, committed, or assigned to expenditure for capital outlays, including the acquisition or construction of capital facilities and other capital assets. Capital projects funds exclude those types of capital-related outflows financed by propriety funds or for assets that will be held in trust for individuals, private organizations, or other governments.
4. ***Debt Service Funds***—To account for and report financial resources that are restricted, committed, or assigned to expenditure for principal and interest. Debt service funds should be used to report resources if legally mandated. Financial resources that are being accumulated for principal and interest maturing in future years also should be reported in debt service funds.
5. ***Permanent Funds***—To account for and report resources that are restricted to the extent that only earnings, and not principal, may be used for purposes that support the reporting government's programs—that is, for the benefit of the government or its citizenry. Permanent funds do not include private-purpose trust funds, which should be used to report situations in which the government is required to use the principal or earnings for the benefit of individuals, private organizations, or other governments.

PROPRIETARY FUNDS

1. ***Enterprise Funds***—To account for operations that are financed and operated in a manner similar to a business enterprise—where there is a fee charged to external users for goods and services.
2. ***Internal Service Funds***—To account for activities that provide goods or services to other funds, departments, or agencies of the primary government and its component units, or to other governments, on a cost reimbursement basis.

FIDUCIARY FUNDS[1]

1. ***Pension (and other employee benefit) Trust Funds***—To account for resources that are required to be held in trust for the members and beneficiaries of defined benefit pension plans, defined contribution plans, postemployment benefit plans other than pension plans, or other employee benefit plans.
2. ***Investment Trust Funds***—To account for the external portion of investment pools reported by sponsoring governments.

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[1] Upon its effective date, GASB Statement No. 84, *Fiduciary Activities*, will change the categories of funds discussed here. Agency funds will no longer exist and there will be a new category of fiduciary funds—custodial funds.

3. ***Private Purpose Trust Funds***—To account for all other trust agreements under which principal and income benefit individuals, private organizations, or other governments.
4. ***Agency Funds***—To account for resources held by the government in a purely custodial capacity.

Is a government required to report all the eleven fund types? No. As stated earlier, the number of funds that a government should use becomes a matter of professional judgment. Many activities of a government can be accounted for in the general fund, or separate funds can be used if needed to increase accountability. However, a government should use the minimum number of funds necessary for sound financial management and/ or to meet legal and accounting requirements. There are only a few instances where GAAP requires the use of specific funds to report certain activities. It is important to note that all governments should have a general fund and there can only be one general fund.

KNOWLEDGE CHECK

4. Which statement is accurate regarding the creation of new funds?

   a. A grant or other restricted revenue source may require the use of a separate fund.
   b. Governments never start a new activity that they want to track separately.
   c. The governing board cannot create a new fund at any time during the year.
   d. A new accounting standard will never create a new fund.

5. Which statement is accurate regarding fiduciary funds?

   a. Investment trust funds are used to account for the external portion of investment pools reported by sponsoring governments.
   b. Private purpose trust funds are not fiduciary funds.
   c. Agency funds are not used to account for resources held by the government in a purely custodial capacity.
   d. An other employee benefit trust fund is not a fiduciary fund.

Overview of the Financial Reporting Model

Before we move on in the course, a basic understanding of the reporting model used by state and local governments would be useful. Remember that accountability is the key financial reporting objective and that fund accounting is one method used to fulfill this objective. One aspect of financial reporting by governments is an emphasis on the activities of funds and fund types. However, governments must also provide financial information about the results of operations and financial condition of the overall government. To meet both of these needs, governments produce two types of financial statements: fund financial statements and government-wide financial statements.

The fund-based statements provide financial information about each of the major funds of a government. As will be discussed more in future chapters, governmental funds use a different measurement focus and basis of accounting than do proprietary funds and fiduciary funds. Because of this difference, it would not be appropriate to report financial information measured differently in the same financial statements. To do so would be similar to comparing apples and oranges. As a result, separate fund-based statements are reported for each fund category.

The separate *fund financial statements* for each fund category are as follows:

- Governmental funds
  - Balance sheet
  - Statement of revenues, expenditures, and changes in fund balances
- Proprietary funds
  - Statement of net position or balance sheet
  - Statement of revenues, expenses, and changes in fund net position
  - Statement of cash flows
- Fiduciary funds
  - Statement of fiduciary net position
  - Statement of changes in fiduciary net position

The government-wide statements are intended to provide information about the financial resources and activities of the overall government. The statements report information about governmental activities and business-type activities and a total for the primary government. Producing these government-wide statements from the fund-based statements is not as simple as it may seem. There are several adjustments that need to be made to the information in the fund-based statements in order to produce meaningful government-wide statements. The major adjustments are as follows:

- Information in the government-wide statements must be reported using the same measurement focus and basis of accounting. To accomplish this, governmental funds information must be converted to the same measurement focus and basis of accounting used by proprietary funds.
- The resources and activities of internal service funds are reported with governmental activities if they mainly serve governmental funds. If they mainly serve enterprise funds, they are reported with business-type activities. They can also be allocated between governmental and business-type activities.
- Intra-governmental activities are eliminated.
- Fiduciary funds are not reported in the government-wide statements.

The fund financial statements must provide a reconciliation to the government-wide statements. The reconciliation provides a summary of the above adjustments.

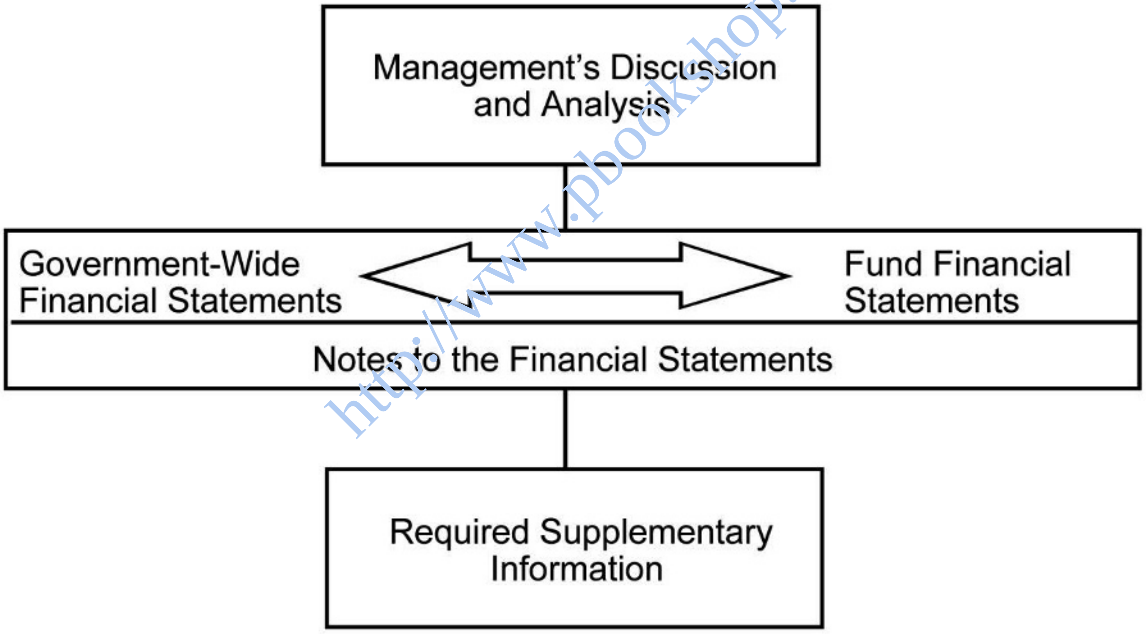
The two *government-wide statements* are:

- Statement of net position
- Statement of activities

Governments are required to report both fund financial statements and government-wide statements in their general purpose external financial statements. GASB requires that general purpose financial statements contain the following, at a minimum:

- Management's Discussion and Analysis (MD&A)
- Basic Financial Statements
  - Government-wide financial statements
  - Fund financial statements
  - Notes to the financial statements
- Required supplementary information (other than MD&A)

The relationship of the different elements that are required for general purpose financial statements can be seen in the following chart. As discussed above, the fund financial statements and government-wide statements provide different information about the government's financial resources. The arrow between the two types of statements emphasizes the fact that the two statements must be reconciled. The reconciliation is presented as part of the fund financial statements or in an accompanying schedule.



Summary

Indeed, state and local governments operate in a different environment than do business organizations. Because of these differences, state and local governments have different reporting objectives, follow different accounting methods, and have an expanded list of financial statement users. Accounting standards are set by GASB for the entities that meet the definition of a government.

In order to meet the financial objective of accountability, governments use funds to report financial resources and activity. Funds are separate accounting entities for which financial statements can be prepared. There are eleven different fund types that fall into three categories: governmental funds, proprietary funds, and fiduciary funds. Governmental funds use a different measurement focus and basis of accounting than do proprietary and fiduciary funds.

Financial reporting by governments must include information about individual major funds and fund categories as well as information about the overall government. Therefore, governments report both fund financial statements and government-wide financial statements. Separate fund financial statements are reported for each of the three fund categories. Two government-wide statements are reported for the overall government: the statement of net position and the statement of activities. The fund financial statements must be reconciled to the government-wide financial statements.

Practice Questions

1. What is a characteristic that distinguishes government from business enterprises?

   a. Organizational purposes.
   b. Sources of revenues.
   c. Role of the budget.
   d. All of the above.

2. What is NOT a financial reporting objective of state and local government?

   a. Comparing actual results to budget.
   b. Assessing cash flows.
   c. Assessing results of operations.
   d. Assisting in the evaluation of efficiency and effectiveness.

3. Who is a primary user of government financial reports?

   a. The citizenry.
   b. Legislative and oversight bodies.
   c. Investors and creditors.
   d. All of the above.

4. What is a key accounting difference for state and local governments?

   a. Budget reporting.
   b. Measurement focus and basis of accounting.
   c. Fund accounting.
   d. All of the above.

5. Which characteristic used to determine if an organization is a government can be rebutted based on compelling, relevant evidence?

   a. The majority of governing board members are appointed by government entities.
   b. An entity that has the power to enact and enforce a property tax levy.
   c. An entity has the ability to directly issue federally tax-exempt debt.
   d. The potential for unilateral dissolution with the net assets reverting to a government upon dissolution.

6. What is a fund category used by governments?

   a. Expendable funds.
   b. Current funds.
   c. Plant funds.
   d. Proprietary funds.